

Industrial development bonds; trade or business test. Bonds issued by a political subdivision for the purpose of constructing an office building to be owned by a tax-exempt hospital that will lease the office space primarily for the individual and private practice of doctors, who are not employees but are affiliated with the hospital, will be industrial development bonds.

'Advice has been requested whether, under the circumstances described below, bonds issued for the purpose of constructing a doctors' office building to be owned by a charitable organization will be industrial development bonds as defined in section 103(b)(2) of the Internal Revenue Code of 1954 even though the charitable organization's leasing of the building to the doctors is not considered an unrelated trade or business.

'City M proposes to issue bonds, the proceeds of which will be used to pay the costs of constructing a professional office and service building. This office building will be sold to X, an organization described in section 501(c)(3) of the Code and exempt from tax under section 501(a). X's charitable purpose is fulfilled by the ownership and operation of a full-purpose medical hospital, which is located adjacent to the planned doctors' office building.

Most of the office space in the building will be leased to doctors who are affiliated with, but not employed by, the hospital. The doctors will use the offices for treating their private patients. The remainder of the building will be leased to tenants who will supply related services such as pharmaceutical and optometric services, and a medical uniforms and supplies store. It has been determined that the existence of the doctors' office building will contribute importantly to the hospital functions by increasing the hospital's efficiency, encouraging fuller utilization of its facilities, and improving the overall quality of its patient care. See Rev. Rul. 69-463, 1969-2 C.B. 131.

'The payment of the principal and interest on the bonds to be issued by M will be secured by a lien on the office building and the rentals received from the tenants.

'Section 103(a)(1) of the Code provides that gross income does not include interest on the obligations of a state, a territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia.

Section 103(b)(1) of the Code provides that, in general, the provisions of section 103(a)(1) will not apply to an industrial development bond.

'Section 103(b)(2) of the Code defines an industrial development bond as any obligation which is issued as part of an

issue all or a major portion of the proceeds of which are to be used directly or indirectly in any trade or business carried on by any person who is not an exempt person, and the payment of principal or interest on which is, in whole or in major part, secured by any interest in property used or to be used in a trade or business or in payments in respect of such property.

'Section 1.103-7(b)(2) of the Income Tax Regulations provides that, for purposes of this subparagraph (which defines exempt person), a tax-exempt organization is an exempt person only with respect to a trade or business it carries on which is not an unrelated trade or business. Whether a particular trade or business carried on by a tax-exempt organization is an unrelated trade or business is determined by applying the rules of section 513(a).

'Section 1.103-7(b)(3)(ii) of the regulations provides, in part, that if the proceeds of a bond issue are to be used to construct facilities to be leased or sold to an exempt person who will, in turn, lease or sell the facilities to a nonexempt person for use in a trade or business it carries on, such proceeds are to be used in a trade or business carried on by a nonexempt person and the debt obligations comprising such issue satisfy the trade or business test.

'Thus, in applying the trade or business test for industrial development bonds, as set forth in section 103(b)(2) of the Code and section 1.103-7(b)(3)(ii) of the regulations, the use of the facility by both the lessor and the lessee must be considered. In the instant case, even though the leasing of the office space might be considered related to X's charitable purposes, the use by the lessees of the office building in their individual trades or businesses is sufficient to satisfy the trade or business test. Since the office building and payment in respect to it are the security for the bonds, the security interest test is also met.

'Accordingly, the bonds proposed to be issued by M will be industrial development bonds as defined in section 103(b)(2) of the Code. If the small issues exemption under section 103(b)(6) does not apply, the interest on the bonds will be included in the gross incomes of the recipients.